MT199213 HR 1/2002

Annuities

by Marsha A. Goetting, Ph.D., CFP, CFCS, Professor and Extension Family Economics Specialist, Montana State University-Bozeman

Outlines how to shop for and choose an annuity and how it can help individuals achieve retirement and estate planning goals.

The word "retirement" may conjure up a variety of im ages — travel, a second home, new hobbies and pursuits. But a comfortable retirement doesn't just happen. Those who have achieved financially satisfying "golden years" have invested in their future by using a number of different retirement savings "building blocks." Individual Retirement Accounts (IRAs), Keoghs, and company pension plans are some ways people put money aside to assure the kind of lifestyle they desire when retired. But after they have taken advantage of these systems for providing income to supplement Social Security, many have also chosen to purchase an annuity. This MontGuide describes what an annuity is, how an annuity works, the types of annuities, how to shop for an annuity, and how an annuity helps individuals achieve their retirement and estate planning goals.

Definition

An annuity is a contract where an individual (annuitant) pays a premium (series of premiums or a lump sum), and in return, the other party agrees to pay a certain amount of money to the individual at stated intervals during that person's lifetime. The income can begin immediately or be deferred to some future date. An annuity is often described as being the opposite of life insurance. An annuity pays while the person lives; life insurance pays when the person dies. An annuity can be purchased separately or in combination with a life insurance policy.

A ***commercial*** annuity is typically issued by an insurance company for cash. An individual pays a sum of money to the company (the insurer) that promises to make periodic payments for the remainder of the annuitant's life. For a larger premium, an annuitant may choose to have the annuity payments continue for his or her survivors or may have a reduced benefit for the same premium..

A ***private*** annuity differs from a commercial annuity in two respects: 1) ordinarily property other than cash (for example, real estate) can be used to acquire the annuity and, 2) the promise to make the payments is made by an individual rather than an insurance company. A private annuity usually ceases upon death of the annuitant.

A private annuity can be used if, for example, parents want to transfer a farm or ranch to a child in exchange for a guaranteed income for life. No mortgage or other security (except life insurance in event of death) may be given to the parents to guarantee payment of the annual amounts by the child. There are some drawbacks and tax ramifications of a private annuity. The parents' future income flow is secured only by the annuity agreement and not by a mortgage on property. Payments made to the parents to satisfy the annuity are not like mortgage payments where the interest portion is tax deductible. If the child sells the real property acquired by the annuity, there may not be a basis in the property so the entire sale could be viewed as a capital gain and subject to income tax. Competent professional and legal advice is recommended for those who want to set up a private annuity to minimize potential adverse legal and tax consequences for the parties involved.

Commercial Annuities

Annuities are usually categorized by when income payments begin, how they are purchased, and by investment performance.

When income begins. An *immediate* annuity starts payments to an individual within 12 months of the annuity purchase date. Immediate annuities are generally purchased by people who have reached retirement age. A *deferred* annuity starts payments more than 12 months subsequent to the purchase date and is stated in the contract or policy. Annuity payments on a deferred annuity are based upon the initial investment of the annuity, plus the interest accumulated prior to and during the distribution of the annuity, minus an administration fee.

Deferred annuities are often purchased by people who are saving money toward retirement.

Some options provide continuing payments to the surviving spouse or other designated survivors if the annuitant should die. Such annuities can serve as a source of retirement income for the annuitant, and as a source of income for the surviving spouse or other beneficiaries.

How annuity is purchased. An annuity can be purchased with a single sum or a series of payments. One purchased with a single sum is called a single payment (or single premium) annuity. Immediate annuities are always purchased with a single sum. An annuity purchased with a series of payments is called a periodic payment annuity or a flexible premium annuity. Deferred annuities may be purchased as a single sum or as a series of payments.

Investment performance. Types distinguished by investment performance are the fixed (guaranteed) annuity or the variable annuity. A fixed or guaranteed annuity provides an interest rate guaranteed by the insurance company. In addition, the company guarantees to return the amount of principal. With a variable annuity, funds are most often invested in a family of mutual funds. Some variable annuities are called "self-directed annuities" because the purchaser has the right to decide into which mutual fund portfolios his or her money is deposited.

With a fixed (guaranteed) annuity, an interest rate is locked in for an initial period, normally one to three years. When the period ends, the insurance company designates a new rate of return for the next period of time. Most fixed annuities have a minimum guaranteed rate that the insurance company will pay regardless of economic conditions. However, there is no guarantee that fixed annuities will pay more or less than inflation. When considering the purchase of a fixed rate annuity, ask an insurance company representative to provide a history of renewal rates.

A variable annuity provides a selection of investment options, typically a family of mutual funds. The purchaser, rather than the insurance company, decides how to allocate the annuity premium among the possible investments. For example, purchasers could choose to have money in aggressive or conservative stock portfolios or aggressive or conservative bond portfolios. Purchasers have the right to transfer among portfolios as their objectives and market conditions change and there will be no tax consequences associated with the transfer.

Variable annuities offer the potential to earn more than with a guaranteed annuity, but the value of the annuity can also decrease because no minimum earnings rate is guaranteed. The rate of return will fluctuate as the value of the underlying mutual fund investment changes. If the value of the underlying mutual fund and the rate of return adjust with inflation, a variable rate annuity may provide some protection against inflation not afforded with a fixed rate annuity. However, there is no guarantee that variable annuities will keep pace with inflation.

Understand the Charges

There are a variety of charges that may be levied against annuity contributions. These factors should be taken into consideration in the purchase of an annuity.

Surrender charge—This is the amount the insurer will charge if funds are withdrawn before a certain period of time. This charge may be as much as 10 percent, and applies during the first five to ten years of the annuity contract.

Annual charge—This is the amount charged for the cost of administering the annuity contract. Annual charges may range from $0 to $40 depending on the amount in the annuity.

Fixed annuity: fees and expenses—The interest rate quoted for a fixed annuity is the amount to be paid to the annuitant after the insurance company deducts fees and expenses from the rate it earns on the underlying investment. Because principal and interest are guaranteed by the insurance company and the purchaser does not decide how the underlying assets are invested, guaranteed or fixed annuities do not provide a prospectus.

Variable annuity: fees and expenses—The annuity prospectus will describe fees and expenses. The annuity sales representative should also explain such fees to a potential purchaser. Variable annuity fees are frequently called mortality and expense risk charges and maintenance charges. These expenses are similar to mutual fund expenses; they may range annually from a quarter of a percent to two percent of the amount of assets in the annuity. There are specific mutual fund fees that generally apply to variable annuity contracts that include maintenance and management investment advisory fees. The management advisory fee offsets the costs of the investment management services that is calculated as a percentage of the fund assets.

Mortality and expense charges— These fees pay for the guarantee the company makes that the purchaser will not outlive the annuity income. These fees make it possible for the company to guarantee the expenses paid will never exceed a certain amount even if the company's cost increases. Most companies charge 1 percent to 1.5 percent annually for these expenses on a variable annuity.

Sales charges, or loads—Unlike traditional mutual funds, most annuities are not assessed a front-end load (sales charge collected at the time of purchase). More common is the back-end load, referred to earlier as a surrender charge. With a back-end load, all money is invested for the purchaser but a charge is deducted when the annuity is cashed in. If an account is held for the full surrender penalty period, there is generally no back-end load charge.

Settlement Options

A ***straight-life*** or ***lifetime-only annuity*** pays the annuitant until death, regardless of whether he or she lives to age 100 or dies shortly after signing the contract. This type of annuity is usually used by people who need larger monthly incomes and do not have dependents or intend to provide financial resources for their dependents in some other way.

A ***life-and-period-certain annuity*** pays the annuitant and a beneficiary for a specified number of years. The typical amount of time is 10, 15, or 20 years. For example, if an annuitant buys a 15 year certain annuity and dies after eight years, his or her beneficiary will receive monthly payments for the remaining seven years of the contract.

An ***installment-refund annuity*** pays the remainder of the original investment to the beneficiary in monthly installments if the annuitant dies but provides lifetime income to the annuitant.

A ***cash-refund annuity*** works like the installment-refund type, except that the survivor receives the balance of the premiums paid to the company in a lump sum.

A ***joint-and-survivor annuity*** pays until both the annuitant and his or her beneficiary are deceased. The amount of the monthly check is based on the ages of the annuitant and his or her survivor. Joint-and-survivor contracts can pay 100 percent, 75 percent, 67 percent or 50 percent of the monthly benefit to a survivor.

Tax Consequences: Income, Estate, and Inheritance

Retirement plans and individual annuities that meet specific legal requirements can offer the additional tax advantage of pre-tax contributions. Several types of employer plans permitting pre-tax contributions are identified in the Internal Revenue Code: 401 (a), 401 (k), 403 (a), 403 (b), and 402 (b) plans; Simplified Employee Pension Plans; and 457 Deferred Compensations Plans. The major advantage of a tax deferred annuity is that, during the accumulation phase, neither contributions nor interest earned are taxed. Contributions funnel directly from employers to an annuity account on a before-tax basis. This effectively lowers gross income and reduces current state and federal income tax liabilities similar to ordinary Individual Retirement Accounts.

An annuity will be included in a decedent's estate for Montana inheritance tax purposes and Federal estate tax purposes unless it is the type of annuity that stops paying upon the death of the original annuitant. The value for tax purposes will be based on two factors: who contributed to the purchase of the annuity and the expected future payout to the beneficiaries of the annuity. An annuity with a named beneficiary is not subject to probate.

Ownership and beneficiary designations of annuity contracts should be coordinated with the owner's overall estate plan.

Rate the Company

The financial health of insurance companies can be evaluated by learning how they are rated by major rating companies such as A. M. Best Company, Duff & Phelps Credit Rating Service, Moody's Investors Service, Standard & Poor's Insurance Rating Services, and Weiss Ratings. Ratings are available in libraries, from insurance agents who sell annuities, or directly from the rating agencies. However, each rating service has a different definition for financial stability. These raters also have different rating codes. To illustrate: an A++ is the top grade from A.M. Best, but second on S&P's and Duff & Phelps's scales. A high rating does not guarantee safety but it is one of the best indicators available for consumers to gauge an insurance company's health.

Annuities for Me?

Annuities can be effective retirement and estate planning tools when you secure proper guidance and advice. Consult a life insurance agent and tax accountant for further information about commercial and private annuities. Contact an attorney for legal implications of a private annuity. Annuity contracts should be reviewed periodically, as a part of the estate and retirement planning process, to assure that the plan is accomplishing your financial goals. When there is a dramatic change in financial situation such as divorce, death of spouse or other beneficiary, or birth of a child, you should review your plans.

Common Annuity Language

***Accumulation period*:** The time during which your fund builds up for a deferred annuity.

***Annuitant*:** The person during whose life the annuity is payable, usually the person who is to receive the annuity.

***Annuity*:** A contract that provides an income for life, a certain number of years, or both.

***Deferred annuity*:** A plan under which income payments begin at some future date.

Fixed Annuity : A plan under which the monthly payments are fixed because they are guaranteed by the insurance company.

Flexible premium retirement annuity: A plan which permits varying contributions from year to year, often used for IRAs.

***Keogh plan*:** A retirement plan for the self-employed in which annuities can be used.

***Loading*:** The fees or charges you pay in purchasing an annuity.

***Mortality table*:** A table showing the death rates at each age.

Owner: One who purchases an annuity.

***Payout Phase*:** The period when you receive the income from your annuity.

***Principal*:** The amount you pay into your annuities as distinguished from the interest which builds up.

Qualified annuity: An annuity which is sold as part of a tax-qualified Keogh plan, a company pension plan, an individual retirement account, a tax-sheltered annuity (403(b)), etc.

***Simplified Employee Pension (SEP)*:** A SEP is a program under which the employer makes contributions to IRAs of employees.

Straight annuity — A plan which pays a predetermined amount—

generally on a monthly basis—but stops payment when you die.

Variable annuity — A plan under which the monthly payments will vary because they are based on stock or other equity investments. This plan is often available on a group basis.

Acknowledgments

This publication has been approved by representatives of the following organizations and agencies who recommend its reading by those who are considering using annuities as estate planning or retirement tools: Business, Estates, Trusts, Tax and Real Property Law Section, State Bar of Montana; Montana Association of Life Underwriters; Montana Insurance Commissioner. The author expresses appreciation to MSU Extension faculty who reviewed the MontGuide and made many helpful suggestions.

References

Blume, Adrienne, "Is Your Life Insurer Healthy? How to Read the Ratings," *Kiplinger's Personal Finance Magazine,* pp. 21-25, September 1991.

Building Your Future With Annuities - A Consumer's Guide. Fidelity Investments, Pueblo, CO, August, 1991.

"Sizing Up The Possibilities." *Focus on Finance*, Vol. 5, No. 1., Variable Annuity Life Insurance Company, Houston, TX, Fall 1990.

Topolnicki, Denise M. "How to Tell if an Immediate Annuity Makes Sense for You." *Money*, May 1989.

Copyright © 2002 MSU Extension Service
We encourage the use of this document for nonprofit educational purposes. This document may be reprinted if no endorsement of a commercial product, service or company is stated or implied, and if appropriate credit is given to the author and the MSU Extension Service. To use these documents in electronic formats, permission must be sought from the Ag/Extension Communications Coordinator, Communications Services, 416 Culbertson Hall, Montana State University-Bozeman, Bozeman, MT 59717; (406) 994-2721; E-mail - publications@montana.edu.
To order additional publications call your local county Extension office, or visit www.montana.edu/publications.

The programs of the MSU Extension Service are available to all people regardless of race, creed, color, sex, disability or national origin. Issued in furtherance of cooperative extension work in agriculture and home economics, acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture, David A. Bryant, Vice Provost and Director, Extension Service, Montana State University, Bozeman, MT 59717.

File under: Consumer Education
D-16 (Estate Planning)
Reprinted Jan. 2002
1000102 ST